# In the Supreme Court of the United States

OCTOBER TERM, 1974

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No. 74-494

ADOLPH K. KRAUSE AND JANET S. KRAUSE, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The sole question raised by the petition is whether transfers to trusts made by petitioners were effective for federal income tax purposes to shift the income from them to the trusts.

In a series of transfers which were made reciprocally pursuant to a single plan, petitioners established six trusts for the benefit of their children and grandchildren, transferred certain of their personal assets to a partnership in return for general and limited partnership interests and, finally, transferred the limited partnership interests to the trusts in return for $100 in cash and rights to future income earned by the transferred partnership interests (Pet. App. A9, A11, A14). The courts below determined that most of these transfers were ineffective to shift the burden of income taxation from

petitioners. They found that the trusts had not become the actual owners of the partnership interests nominally transferred to them and that therefore partnership income was still taxable to petitioners, as general partners in the partnership. The courts below further held that, under the grantor trust rules of Sections 671 through 678 of the Internal Revenue Code of 1954, which tax the income of a trust to a settlor who retains significant control over the trust, petitioners were taxable on a substantial portion of the nonpartnership income earned by the trusts.

1. Section 704(e) of the Code provides that for tax purposes a person shall be recognized as a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor. As the committee reports (H. Rep. No. 586, 82d Cong., 1st Sess., p. 33; S. Rep. No. 781, 82d Cong., 1st Sess., pp. 39-40) accompanying the passage of the predecessor to that provision state, the benefits of Section 704(e) were to be accorded only to transfers which effectively conveyed ownership of partnership interests. To implement this clearly stated congressional purpose, the Treasury Regulations (Section 1.704-1(e)(1)(iii)) require that "a transfer [of a partnership interest] must vest dominion and control of the partnership interest in the transferee," and that "[a] transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest."

Both courts below found that petitioners retained such incidents of ownership over the partnership interests purportedly transferred to the trusts so that the trusts could not be regarded as bona fide partners. As a result, the income attributable to the partnership interest was taxable to petitioners (Pet. App. A4-A5, A21).

The record supports that factual determination. Each petitioner was the grantor of three of the trusts and, as grantor, gave his spouse the power to remove any trustee of the trust. The trustees, who thus served at the pleasure of the grantor's spouse, were granted a power to invade trust income and corpus (apparently including the partnership interest) for the "care, comfort, and necessities" of the grantor's spouse and, upon termination of the trust, in their "sole and absolute discretion" to distribute trust corpus and accumulated income to that spouse (Pet. App. A13).

The partnership agreement, in turn, provided that none of the limited partnership interests held by the trusts could be transferred without the approval of the petitioners, as general partners, and further provided that the contributions of the limited partners might be retained for use in the partnership for an unlimited length of time. The corpus available for distribution to the petitioners thus would contain the partnership interests unless petitioners were to free the trusts from the strictures of the partnership agreement.

Nor was that the limit of petitioners' dominion over the allegedly transferred partnership interests. The contracts transferring the partnership interests to the trusts provided that petitioners were to receive 80 percent of the partnership income distributed to the trusts. If the trusts failed to pay over this percentage share within the specified time, the trusts would forfeit whatever interests in the partnership they had acquired. Petitioners, however, controlled distributions of partnership income and thus had the power to revoke the entire transaction (Pet. App. A14-A17, A20). On this record, the trusts were in no meaningful respect the actual "owners" of the partnership interests nominally transferred to them.

Petitioners contend (Pet. 5-7) that the decision below conflicts with *Bateman* v. *United States,* 490 F. 2d 549 (C.A. 9). There, the taxpayer transferred limited partnership interests to a number of 10-year trusts. The court found that those trusts became the actual owners of the transferred interests and therefore accorded the transfers tax recognition.

The differences between the terms of transfer and the trust instruments there involved and those here at issue justify the differences in outcome. In *Bateman,* the limited partnership interests which were granted tax recognition were transferable and the income attributable to those interests vested irrevocably in the trust beneficiaries. The transfers in that case did not have any of the voidable characteristics which so predominate here. Finally, unlike this case, the taxpayers in *Bateman* did not have sufficient control over the trusts to be taxable on trust income under the grantor trust provisions of Section 671 through 678 of the Code.[1]

2. Petitioners further argue (Pet. 13-15) that the application of the reciprocal trust doctrine by the courts below is inconsistent with *United States* v. *Estate of Grace,* 395 U.S. 316. There, this Court noted that the reciprocal trust doctrine, under which grantors of reciprocal trusts are treated for tax purposes as grantors

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[1]Nor is there any basis for petitioners' assertion that the decision below conflicts with *United States* v. *Byrum,* 408 U.S. 125. That case arose under a different statutory provision—there the question was whether the decedent's retention of voting power for certain transferred stock amounted to the retention of either the right to receive the income attributable to the transferred stock or the right to designate who would receive that income under Section 2036 of the Code. Moreover, petitioners' rights and powers over the purportedly transferred partnership interests were considerably more extensive than the mere retention of voting rights at issue in *Byrum.*

of the trust which crossed their own, originated in an attempt to give tax effect to the practical substance of a transaction, rather than to the legal forms into which the transaction had been forced. While *Estate of Grace* involved estate taxes, the substance-over-form rationale underlying the reciprocal trust doctrine is equally applicable to the income tax. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. Indeed, the doctrine has often been applied in income tax cases. See *e.g.*, *Estate of Newberry* v. *Commissioner*, 17 T.C. 597, 605, reversed on other grounds, 201 F. 2d 874 (C.A. 3); *Tobin* v. *Commissioner*, 11 T.C. 928, 946, reversed in part on other grounds, 183 F. 2d 919 (C.A. 5); *Haldeman* v. *Commissioner*, 6 T.C. 345, 356; *Wieboldt* v. *Commissioner*, 5 T.C. 946, 954.

Nor is there anything in this case which militates against application of the reciprocal trust doctrine. Each petitioner explicitly gave his spouse substantial powers over the trusts he created. As petitioners tacitly concede (Pet. 13-17), these powers were so extensive that had they each been grantor of the trusts over which they held those powers, the trusts' income would have been taxable to them. See Section 677(a)(2); cf. *Duffy* v. *United States*, 487 F. 2d 282 (C.A. 6). The decision below held that to the extent that there was a mutuality to the assets crossing in these trusts,[2] each petitioner should be considered the grantor of the reciprocal trust and taxed accordingly. This is fully in keeping with *Estate of Grace* where the Court stated (395 U.S. at 324):

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[2]Petitioner Adolph Krause transferred $100 in cash and 50 shares of Wolverine stock to each of the children's trusts and petitioner Janet Krause transferred $100 in cash and 25 shares of Wolverine stock to each of the grandchildren's trusts (Pet. App. A11-A12). The Tax Court accordingly determined that the extent of the mutual value was 25 shares of Wolverine stock, *i.e.*, each was taxable on the trust income attributable to 25 shares of Wolverine stock.

> * * * we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
*Solicitor General.*

DECEMBER 1974.

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